Letter Ruling 02-3: Tax Consequences to Shareholders in F Reorganization with Partnership as Parent Entity

July 16, 2002

You have requested a ruling on behalf of ********** a Massachusetts corporation ("Holding"), and its wholly owned subsidiary, ********** a Massachusetts corporation ("Company"), under a proposed reorganization that would result in Holding becoming a direct wholly owned subsidiary of a general partnership ("Partnership") and, therefore, in Company becoming a second-tier subsidiary of a Partnership. (Holding and Company may hereafter be referred to collectively as "Taxpayers.") The proposed reorganization is described in greater detail below.

I. Facts

A. Background

Company is a Massachusetts corporation that manufactures and applies a sealant. Holding owns all of the stock in Company. Three shareholders ("Shareholders") own all the stock in Holding. Shareholders are all Massachusetts residents. One Shareholder owns 52% of the stock, and the other two Shareholders each own 24% of the stock. Prior to the transaction at issue, Holding elected S corporation treatment for itself and qualified S corporation subsidiary ("QSUB") treatment for Company.

B. Proposed Transaction

For various business reasons, Shareholders propose to reorganize by transferring all of their shares in Holding to Partnership, thereby making Holding wholly owned by Partnership ("Reorganization"). Each Shareholder's ownership in the business will be represented by Partnership interests in the same proportion as their current shares in Holding. For federal tax purposes, Partnership will elect to be treated as a corporation under the Code § 7701 check-the-box regulations. Taxpayers represent that, in the absence of the check-the-box election, Partnership would be classified as a partnership for federal income tax purposes under Treas. Reg. § 301.7701-2 (as in effect prior to January 1, 1997).[1]

Effective with the date of its formation, Partnership will also elect to be treated as an S corporation and to treat Holding as a QSUB, under Code §§ 1362 and 1361, respectively. Taxpayers represent that Company will characterize this series of transfers and elections as a Code § 368(a)(1)(F) reorganization (sometimes called an "F reorganization") on its federal tax return. Taxpayers also represent that Holding and Company will each be a valid QSUB.

II. Rulings Requested

Holding and Company request the following rulings in connection with the Reorganization:

1. All of Holding's and Company's items of income, gain, loss, deduction and credit will be treated as those of Partnership.

2. Partnership income will not be subject to the taxes imposed by chapter 62 of the Massachusetts General Laws. Instead, the income, gain, loss, deductions, and credits of Partnership will flow through from Partnership to Shareholders based on their interests in Partnership.

3. Holding and Company will not be subject either to the net income measure of the corporate excise imposed under G.L. c. 63, § 32 or to the entity-level income tax imposed under G.L. c. 63, § 32D.

4. Under G.L. c. 63, § 32, Holding and Company will each be subject to the greater of the non-income measure of the corporate excise or the minimum corporate excise.

5. When either Company or Holding engages in an activity that can generate a credit under either G.L. c. 62 or 63, Partnership and Holding, or Company, as the case may be, may agree that such credit may either flow through from Partnership to Shareholders if it is a G.L. c. 62 credit, or be claimed by Holding or Company, as the case may be, against the non-income measure of the corporate excise liability if it is a G.L. c. 63 credit.

6. For Massachusetts purposes, the Reorganization will be treated as tax-free to Shareholders under G.L. c. 62.

III. Discussion

In LR 01-1, the Department ruled on a reorganization, similar to the proposed Reorganization, concerning the following transactions and elections. A company, which owned a QSUB, became wholly owned by a general partnership; the general partnership elected to be treated as a corporation under the check-the-box regulations (but in the absence of the check-the-box regulations would have been treated as a partnership); the partnership further elected to be treated as an S corporation effective with the date of its formation; and the partnership and the company made an election to treat the company as a QSUB under Code § 1361(b)(3)(B)(ii). Federally, this series of transfers and elections was treated as tax-free and qualified as a Code § 368(a)(1)(F) reorganization. After the reorganization described in LR 01-1, the original shareholders owned partnership interests in a partnership (treated as a corporation under check-the-box rules) that elected to be an S corporation.

The ownership chain described in LR 01-1 parallels the ownership chain of the proposed Reorganization. Accordingly, the following rulings expressed in LR 01-1 will apply to the proposed Reorganization. First, Partnership will be treated as an S corporation under the Code, but in Massachusetts all of Holding and Company's items of income, gain, loss and deduction will be treated as though realized by the Shareholders, who will report their income under the Massachusetts partnership tax provision, G.L. c. 62, § 17. Second, the two QSUBs (Holding and Company) will not be subject to the net income measure of the corporate excise under G.L. c. 63, § 32, nor to the entity-level income tax imposed under G.L. c. 63, § 32D. Third, each QSUB, if it is doing business in Massachusetts, will be treated as a corporation for purposes of the property measure of the corporate excise in chapter 63, and will be separately subject to the greater of the excise under the property measure of the corporate excise or the minimum corporate excise. *See* TIR 97-6. Fourth, when one or both of the QSUBs engages in an activity that can generate a credit under either G.L. c. 62 or G.L. c. 63, Partnership and the QSUBs may agree, if the credit is available to any of them, which of them will take that activity into account in determining the credit. While it is possible for the same activity to generate a credit for either the partners or one of the QSUBs, the credit may be claimed in connection with only one entity, either the Partnership or one of the

QSUBs. See LR 01-1. Note, however, that the only credits available to a Partnership on a flow-through basis are those allowed under G.L. c. 62. By the same token, a QSUB is taxed under G.L. c. 63 and may claim only those credits allowed under that chapter. *See* DD 00-9 and CMR 62.17A.1(3)(d).

The only new question raised by this letter ruling request is whether the Reorganization will be treated as tax free to Shareholders under G.L. c. 62. In Directive 00-9, the Department ruled that it would follow federal non-recognition of income treatment as a result of reorganizations qualifying under Code § 368(a)(1)(F) in which the resulting parent entity was a corporate trust. Such treatment is statutorily required under G.L. c. 62, § 8(a), which states that "for purposes of any determination involving sections three hundred and fifty-one through three hundred and sixty-eight of the Code any corporate trust shall be treated as a corporation." We have not, however, previously ruled on the impact to shareholders in connection with a tax-free federal F reorganization, like the one at issue in this request, in which the parent entity is a general partnership rather than a corporate trust.

We ruled in LR 01-1 that after a federally tax-free F reorganization in which shareholders transferred all of the shares of a company to a general partnership (treated federally as a corporation under check-the-box rules), all of the company's items of income, gain, loss, deduction and credit would be treated as though realized by the partners in the general partnership, but the question of the tax impact of the reorganization on the transferring shareholders was not raised.

In this case, the parent entity is a partnership in Massachusetts, while at the federal level it is treated as a corporation under the check-the-box rules. We have previously ruled that a general partnership that elects to be treated as a corporation for federal income tax purposes will still be treated as a partnership for Massachusetts purposes. L.R. 01-1, L.R. 99-13. Code § 368(a)(1)(F), by its terms, applies to corporations, not partnerships. Because Partnership is a different entity at the state level than it is at the federal level, the fact that this transaction does not trigger federal tax to Shareholders does not necessarily resolve the issue in Massachusetts.

Federal gross income as defined under the Code of January 1, 1998, is, however, the starting point in calculating Massachusetts gross income for personal income tax. G.L. c. 62, § 2(a). For federal purposes, according to Taxpayers' representation, Reorganization will be treated as an F reorganization and therefore will not trigger the recognition of any income to Shareholders under the Code. Code § 354(a)(1). Because Massachusetts gross income refers to federal gross income and Shareholders will not recognize federal taxable gain as a consequence of Reorganization, we rule that Reorganization will not cause Shareholders to recognize Massachusetts income.[2]

IV. Conclusions

On the facts you have presented, we rule as follows:

1. All of Holding's and Company's items of income, gain, loss, deduction and credit will be treated as those of Partnership.

2. Partnership income will not be subject to the taxes imposed by chapter 62 of the Massachusetts General Laws. Instead, the income, gain, loss, deductions, and credits of Partnership will flow through from Partnership to its partners based on their interests in Partnership.

3. Holding and Company will not be subject either to the net income measure of the corporate excise imposed under G.L. c. 63, § 32 or to the entity-level income tax imposed under G.L. c. 63, § 32D.

4. Under G.L. c. 63, § 32, Holding and Company will each be subject to the greater of the non-income measure of the corporate excise or the minimum corporate excise.

5. When either Company or Holding engages in an activity that can generate a credit under either G.L. c. 62 or 63, Partnership and Holding, or Company, as the case may be, may agree that such credit may either flow through from Partnership to its partners if it is a G.L. c. 62 credit, or be claimed by Holding or Company, as the case may be, against the non-income measure of the corporate

excise liability if it is a G.L. c. 63 credit.

6. For Massachusetts tax purposes, the Reorganization will be treated as tax-free to Shareholders under G.L. c. 62.

Very truly yours,

/s/Alan LeBovidge

Alan L. LeBovidge
Commissioner of Revenue

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[1] In particular, Taxpayers represent that Partnership will lack centralized management, continuity of life, free transferability of interests and limited liability, which are the four corporate attributes listed in Treas. Reg. § 301.7701-1 (as in effect prior to January 1, 1997).

[2] We note that Shareholders will be subject to Massachusetts tax on any federally taxable gain realized in connection with distributions from the Partnership or a redemption of the Partnership interest.